Demystifying Causation in Fraud-on-the-Market Actions

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An issuer makes a positive, material misstatement in violation of Rule 10b-5. What must an investor who purchases the issuer’s shares on the open market show to establish causation in a “fraud-on-the-market” action for damages? After years of confusion in the lower courts, the Supreme Court recently granted certiorari on the question in the case of Broudo v. Dura Pharmaceuticals.¹

This Article argues that the confusion in the lower courts has arisen because they have analyzed the issue in terms of the twin concepts of “transaction causation” and “loss causation.” They initially developed this bifurcated framework as a way of deciding causation in actions based on a showing of traditional reliance, which involve the plaintiff establishing that the defendant’s misstatement caused the plaintiff to engage in what has turned out to be a losing transaction. Fraud-on-the-market actions involve a fundamentally different kind of causal connection between the defendant’s misstatement and the plaintiff’s injury. The plaintiff must instead establish that the defendant’s misstatement caused her to pay a higher price for her purchase, not that it caused her to make the purchase. This difference in causal connection was recognized by the Court when it originally approved fraud-on-the-market actions in Basic v. Levinson² more than fifteen years

¹ 339 F.3d 933 (9th Cir. 2003), cert. granted, 124 S. Ct. 2904 (2004).
² Basic Inc. v. Levinson, 485 U.S. 224 (1988). Basic is discussed in more detail later, in Part II.A.

The rule in Basic applies both to suits by secondary market purchasers in cases of falsely positive statements, and to suits by secondary market sellers in the cases of falsely negative statements. The actual facts in Basic involved a suit by a purchaser based on a falsely positive statement because these suits are far more common, as exemplified by Dura, infra Part V.A, and because the question certified by the Court, which refers to “a causal connection between the alleged fraud and the investment’s subsequent decline in price” assumes such a suit. Brief for the United States as Amicus Curiae at 1, Dura Pharmas., Inc. v. Broudo, 2004 WL 1205204, at *1 (2004) (No. 03-932) [hereinafter Cert. Pet. Amicus Brief for the United States]. Moreover, it is expositionally more convenient to discuss only one kind of misstatement. Presumably, however, in the case of suit by a seller based on an allegedly false statement, imposition of the kind of traditional loss causation requirement sought by the defendants in Dura would mean that the plaintiff would need to show that the alleged fraud led to the share’s subsequent increase in price. Everything I have to say about such a loss causation requirement,
ago. Because of this fundamental difference in causal connection, the twin concepts of transaction causation and loss causation simply do not make sense in fraud-on-the-market actions.

The Court in its upcoming decision in *Broudo* concerning fraud-on-the-market actions should, consistent with the causal link it recognized in *Basic*, avoid the use of this inappropriate transaction causation/loss causation framework. Its focus instead should be on developing standards for what the plaintiff must plead and prove in order to establish that the defendant’s misstatement inflated the price at the time of purchase.

Part I of this Article discusses how the concepts of transaction causation and loss causation originally developed in the case law. This development occurred exclusively in the context of actions based on a showing of traditional reliance. Traditional reliance based actions typically arise out of either face-to-face transactions or transactions in a thin or initial public offering market. These are situations where the purchase price paid by the plaintiff is not determined or guided by a price in an established, efficient secondary trading market. Only in these situations is there usually any prospect of demonstrating traditional reliance. The transaction causation/loss causation framework makes reasonable sense for this kind of situation. Part II discusses fraud-on-the-market actions, which arise out of purchases in an efficient secondary trading market. Despite the recognition in *Basic* of the fundamental difference between traditional reliance based actions and fraud-on-the-market actions in terms of the causal link between defendant’s misstatement and plaintiff’s injury, the lower courts appear to continue to feel bound to analyze causation in fraud-on-the-market actions using the same transaction causation/loss causation framework that they had developed for traditional reliance based actions. A review of the cases reveals a struggle to fit a square peg into a round hole that has produced a welter of conflicting rulings, often supported by tortured reasoning or bent facts. Part III argues that the focus for analyzing causation in fraud-on-the-market actions should instead be on developing standards for what the plaintiff needs to plead and prove in order to establish that the defendant’s misstatement inflated the price paid. This question is explored in terms of the practical effects of different rules on settlements and adjudicated outcomes and their implications for larger questions of policy. Part IV sets out and answers some of the common arguments made in favor of requiring plaintiffs in fraud-on-the-market actions to show traditional loss causation, i.e., a causal connection between the corporate misstatement and a subsequent decline in price. Part V applies the approach recommended here to *Broudo*. Part VI concludes.

I. CAUSATION IN ACTIONS BASED ON TRADITIONAL RELIANCE

A. THE ORIGINS OF THE TRANSACTION CAUSATION/LOSS CAUSATION FRAMEWORK

The twin requirements of transaction causation and loss causation were developed in the context of Rule 10b-5 fraud cases where plaintiffs were able to show and causation more generally, would apply equally to a suit by a plaintiff based on a falsely negative statement.
traditional reliance. The seminal case defining traditional reliance is the Second Circuit’s 1965 opinion in List v. Fashion Park, Inc. The district court in List found that the plaintiff, with regard to one of his allegations, would have purchased even if he had known the true situation. On the basis of this finding, the district court dismissed the claim relating to this allegation. The Second Circuit affirmed. In reaching this decision, it started with a ruling that the requirement in common law misrepresentation cases that the plaintiff show “reliance” “carried over into civil suits under Rule 10b-5.” Citing common law authorities, the court found that “the test of ‘reliance’ is whether ‘the misrepresentation is a substantial factor in determining the course of conduct which results in [the recipient’s] loss.’” The court stated “[t]he reason for this requirement . . . is to certify that the conduct of the defendant actually caused the plaintiff’s injury.”

List left an open question. Suppose the plaintiff had been able to show that he would not have purchased had he known the true situation. Would that by itself have been sufficient to establish causation? A positive answer would mean that any person who made a misleading statement in violation of Rule 10b-5 would be liable to anyone who could show that the statement was a “but for” cause of the purchase of a security that subsequently declined in price. The plaintiff would essentially be complaining to the defendant: “You got me into this through your violation and, because I got into it, I suffered a loss for which you should make me whole.” This, however, was not the route chosen by the federal courts in working out the contours of the implied right of action under Rule 10b-5. Over time, a clear requirement developed that a plaintiff basing a claim on a showing that the defendant’s 10b-5 violation impelled her into making a securities purchase must show something more for liability to be imposed.

The first signs that a showing of something more was required appeared in 1969 in another Second Circuit opinion, Globus v. Law Research Service, Inc. In Globus, the jury found defendants, who had made misleading statements in violation of Rule 10b-5 in a circular for a stock offering, were liable to plaintiffs, who had presented evidence that they had been attracted by the misleading statements into purchasing some of the offered shares and subsequently sustained a loss.
On appeal, defendants argued that the jury instructions on causation were improper and that there was insufficient evidence of causation. The jury instructions were that “the plaintiff is required to prove . . . that he or she suffered damages as a proximate result of the alleged misleading statements and purchase of stock in reliance to them. In other words . . . that the damage was either a direct result or a reasonably foreseeable result of the misleading statement.” The court described these as “clear instructions on causation” and found that they “were sufficient to bring home the basic concept that causation must be proved else defendants could be held liable to all the world.” As for the evidence, the appeals court observed that the plaintiffs not only introduced evidence that the statements were a “but for” cause of the purchases, but that the jury could infer that the stock price was bloated as a result of the statement. The court held that this “was sufficient evidence to support a finding of causal relationship between the misrepresentation and the losses appellees incurred when they sold.” Thus, although the court did not explicitly say that a showing of more than just traditional reliance was required, it did, in response to a defendant’s argument that more needed to be shown, approvingly recite jury instructions that appeared to call for a showing of more and point to evidence suggesting the existence of more than just “but for” causation.

Five years later, in Schlick v. Penn-Dixie Cement Corp., the Second Circuit moved one step further toward a clear requirement that a plaintiff who bases a claim on a showing that the defendant’s 10b-5 violation impelled her into making a securities purchase must show something more. Introducing for the first time into the case law the terms “loss causation” and “transaction causation,” the court stated in dicta:

This is not a case where the 10b-5 claim is based solely upon material omissions or misstatements in the proxy materials. Were it so, concededly there would have to be a showing of both loss causation—that the misrepresentations or omissions caused the economic harm—and transaction causation—that the violations in question caused the appellant to engage in the transaction in question.

It added, however, that the something more that needed to be shown, what it termed “loss causation,” was “demonstrated rather easily by proof of some form of economic damage.” Finally in 1981, the Fifth Circuit provided a clear appel-
late court ruling that a showing of something more was required. In *Huddleston v. Herman & MacLean*, the court, in finding that the trial court’s failure to submit issues of reliance and causation to the jury required a new trial, stated:

The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss. The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment’s decline in value.23

The *Huddleston* court links these two requirements to the transaction causation/loss causation language used by other courts.24

**B. THE TRANSACTION CAUSATION/LOSS CAUSATION FRAMEWORK FITS TRADITIONAL RELIANCE-BASED ACTIONS REASONABLY WELL**

The twin requirements of transaction causation and loss causation are now firmly established.25 In the context of an action based on traditional reliance, their meanings are fairly settled. Transaction causation involves a showing that the plaintiff would not have purchased “but for” the misstatement.26 Loss causation in this context follows on from this first showing. It involves the additional showing that the purchased security declined in value from what was paid (or was sold at a loss) and that the decline or loss was in some way reasonably related to the falsity of the statement that induced the purchase.27 These twin requirements fit neatly within traditional reliance based actions and in this context have a reasonably sensible rationale. The objection to imposing liability based on a showing of transaction causation alone is the same as it would be to imposing liability for every injury for which an act of negligence is a “but for” cause. As every first-year law student learns, the chain of “but for” results flowing from any act of negligence can go on forever and ultimately encompass an infinite number of injuries. For most or all of these injuries, it would be ridiculous to hold the actor responsible. Thus, a showing of something more than “but for” causation is required. In tort, the “something more” is proximate cause. In Rule 10b-5 misleading statement cases based on traditional reliance, the “something more” is loss causation. In

22. 640 F.2d 534 (5th Cir. 1981).
23. Id. at 549.
24. The court in *Huddleston* says that courts sometimes consider reliance to be a component of causation and that “the term ‘transaction causation’ is used to describe the requirement that the defendant’s fraud must precipitate the investment decision” and is “necessarily closely related to” reliance. Id. at 549 n.24 “Loss causation,” it continues, “refers to a direct causal link between the misstatement and the claimant’s economic loss.” Id.
25. See Suez Equity Investors v. Toronto-Dominion Bank, 230 F.3d 87, 95 (2d Cir. 2001) (stating “[i]t is settled that causation under federal securities laws is two-pronged . . . both transaction causation . . . and loss causation”). For a survey of the cases requiring loss causation, see Michael J. Kaufman, SECURITIES LITIGATION: DAMAGES § 11:1 (West 2003).
27. Id.
each case, the “something more” involves at a minimum a showing that the wrongful act somehow raised the probability that the plaintiff would suffer a loss of the kind that she did in fact suffer.

There is also a reasonable, though not quite as compelling, rationale for the requirement that the loss be in the form of a sale at a lower price than the plaintiff paid (or, if the plaintiff still holds the security at the time suit is brought, a decline in the market price from the price paid) rather than in the form of the amount extra that the plaintiff paid as a result of the misstatement. The rationale involves an ex post perspective rather than the ex ante perspective that is characteristic of modern, economics-based securities law analysis. It relies on the observation that being induced by a misstatement into making a securities purchase does not by itself inherently mean that the purchaser will ultimately be worse off. The inducement simply puts the purchaser in a position to enjoy all kinds of possible gains and suffer all kinds of possible losses. If the purchaser ultimately does realize a loss and the loss is one that would have been predictable given knowledge of the true state of affairs, then, the thinking goes, an injury has occurred for which the person who made the misstatement in violation of Rule 10b-5 should be liable.

The critical first step in developing the rationale for this requirement of a loss at sale or decline in price is to recognize that an action based on a showing of traditional reliance typically grows out of a face-to-face purchase of shares of a nonpublicly traded issuer or a purchase at or about the time of an initial public offering. In these situations, the price that the plaintiff pays is not one established in an efficient secondary market. As a consequence, the value of the security is much more subjective and the relationship between the misleading statement and the price that the plaintiff paid is unclear. Unlike what I will contend should be the proper approach with fraud-on-the-market actions, the focus in traditional reliance based actions should not, the argument for the rationale goes, be on the difference created by the misstatement between the price paid and value of the security, nor on the effect of the misstatement on the price paid. This is because how low a price, if any, it would have taken for this particular plaintiff to have been willing to buy had she been aware of the truth—the measure of price inflation for this particular plaintiff—is inherently unknowable. The focus instead should be on two facts. First, whatever the value of the security at the time of purchase relative to the price paid, this particular plaintiff would not have purchased at the price offered if she had known the truth. Second, the risks that the truth would have revealed have in fact realized themselves.

It may be easiest to conceptualize the requirement of a loss at sale or decline in price as related to a modified form of rescissionary damages. This form of damages is called for because of the special situations that typically give rise to traditional reliance based actions, where the price the plaintiff paid has not been

28. See infra Part III.B.
29. As one district court, quoted in Basic, put it, “[i]n face-to-face transactions, the inquiry into an investor’s reliance upon information is into the subjective pricing of that information by that investor.” In re LTV Sec. Litig., 88 F.R.D. 134, 143 (N.D. Tex. 1980) (quoted in Basic, Inc. v. Levinson, 485 U.S. 224, 244 (1988)).
set in an efficient secondary trading market. Pure recissionary damages would be the difference between the price paid and the price that the securities were sold (or, if still held, the price at the time the suit was brought). Modified recissionary damages would start with this measure but reduce or eliminate the damages to the extent that the loss or decline was due to factors other than ones related to the false statement. This modified recissionary measure of damages fits nicely with the idea that the defendant’s wrongful misstatement put plaintiff in the position of potentially suffering losses, and that as a result there should be compensation for any losses that in fact do occur, but not if the losses arose from reasons unrelated to the misstatement.

It should be emphasized that this rationale for requiring an *ex post* loss is driven by the face-to-face or thin market situations that are associated with most traditional reliance based cases and the special measure of damages that these situations may suggest. It is only logical that in an action for compensatory damages, the form of loss for which we make a causation determination should correspond to the measure of damages. Compensatory damages, after all, are supposed to measure loss. The standard measure of damages in Rule 10b-5 cases is “out of pocket” damages: the extra amount the plaintiff pays because of the misstatement. The form of loss that corresponds to this measure of damages is the amount by which the misstatement inflates the price the plaintiff pays. Thus, the particular situations where traditional reliance based fraud actions arise are what call for the special semi-recissionary measure of damages. It is this special measure of damages that in turn call for looking for the causes of an *ex post* injury rather than for the causes of an injury at the time of purchase, as should be the case with standard Rule 10b-5 cases including fraud-on-the-market cases.

II. CAUSATION IN FRAUD-ON-THE-MARKET CASES

A. THE DIFFERENCE IN CAUSAL LINK

Fraud-on-the-market actions are distinctly different from actions based on traditional reliance. As discussed above, the plaintiff in a traditional reliance based
action needs to show that she would have acted differently “but for” the wrongful misstatement. At a minimum, this requires that the plaintiff have been aware of the statement. The fraud-on-the-market theory, approved by the Court in 1988 in Basic v. Levinson, provides the plaintiff an alternative way to demonstrate “the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury.”32 This alternative is to show that the misstatement caused the price the plaintiff paid at the time of purchase to be too high, an effect that can be presumed in the case of a material misstatement by an official of an issuer whose shares trade in an efficient market.33

The Court insisted in Basic that its ruling maintained the need for plaintiff to show reliance, just in the form of “reliance on the integrity of [the market] price” instead of reliance on the misstatement itself.34 There is a big difference between these two forms of reliance, however. Unlike traditional reliance, the plaintiff no longer needs to show she would have acted differently—i.e., not purchased the security—if the defendant had not made the misstatement.

B. THE TRANSACTION CAUSATION/LOSS CAUSATION FRAMEWORK FITS FRAUD-ON-THE-MARKET ACTIONS POORLY

As a result of this difference in causal link, the twin requirements of transaction causation and loss causation fit very poorly with fraud-on-the-market actions. In these actions, the typical plaintiff is a member of a class predominantly consisting of portfolio investors who have made impersonal purchases of shares in the secondary market on the New York Stock Exchange or the National Association of Securities Dealers Automated Quotations. As noted, the plaintiff need not allege that she relied on the misstatement. Indeed, she may well not have been aware of it. Even if she were, the misstatement is unlikely to have been decisive in her decision to purchase, because the misstatement, although making the stock appear more attractive than it really is, would also have made it commensurately more expensive. Thus, whether she was aware of the statement or not, she likely would have made the purchase even if the misstatement had not been made, just at a lower price. Consequently, the misstatement is not likely to be a “but for” cause for the purchase. The fact that for most fraud-on-the-market plaintiffs the defendant’s misstatement is not a “but for” cause for their purchase renders both elements of the transaction causation/loss causation framework nonsensical.

1. Transaction Causation

Transaction causation, as we have seen, involves a showing that the plaintiff would not have purchased “but for” the misstatement. Thus, transaction causation is just another name for traditional reliance. If courts seriously imposed a trans-

32. Basic, 485 U.S. at 243.
33. Id. at 245.
34. Id. at 247.
action causation requirement in fraud-on-the-market cases, they would be acting in direct contradiction to Basic. The whole purpose of Basic was to provide the purchaser in the secondary trading markets for whom demonstrating traditional reliance would be an unrealistic evidentiary burden an alternative way to demonstrate the causal connection between a defendant’s misrepresentation and her injury.35

2. Loss Causation

Once it is recognized that requiring fraud-on-the-market plaintiffs to show transaction causation is inconsistent with Basic, it becomes clear that the loss causation requirement makes no sense either. Remember that the loss causation requirement is a follow on to transaction causation. If, to impose liability on a defendant, all that an investor has to show is that she was induced into purchasing shares by the defendant’s misstatement—i.e., transaction causation—the defendant would be insuring the plaintiff against every risk that could possibly depress price below the price paid at time of purchase, including risks totally unrelated to the misstatement. Loss causation is the requirement of “something more,” akin to proximate cause in negligence, that prevents such wide ranging liability.

A loss causation requirement serves no comparable purpose in a fraud-on-the-market action because imposing liability based solely on a showing of this special kind of “reliance” does not lead to similarly wide-open results. The “causal connection between a defendant’s misrepresentation and a plaintiff’s injury”36 is simply different. The plaintiff, rather than saying to the defendant, “you got me into this and now I’ve suffered a loss,” is saying, “I might have purchased anyway even without your misstatement, but your misstatement made me pay more than I otherwise would have.” The claimed loss—that plaintiff paid too much—flows directly from the misstatement. If proved true, the resulting damages paid to the plaintiff compensate the plaintiff for that loss and nothing more. No insurance for any other kind of risk would be provided.

C. The History of the Application of the Transaction Causation/Loss Causation Framework to Fraud-on-the-Market Cases

Although the Supreme Court has never discussed the matter, the lower courts have consistently said over the last twenty years that plaintiffs must show both transaction causation and loss causation in all Rule 10b-5 damage actions, whether based on traditional reliance or on the fraud-on-the-market theory.37 Having de-

35. Id. at 245.
36. Id. at 243.
37. See Suez Equity Investors v. Toronto-Dominion Bank, 250 F.3d 87, 95 (2d Cir. 2001) (stating “[i]t is settled that causation under federal securities laws is two-pronged: . . . both transaction causation . . . and loss causation”). As discussed previously in Part I, the origins of these twin requirements go back to Globus v. Law Research Service, Inc. in 1969 and Schlick v. Penn-Dixie in 1974. See supra notes 11–21 and accompanying text. By 1981, in Huddleston v. Herman & MacLean, 640 F.2d 534 (5th Cir. 1981), there was a clear appellate court ruling that a showing of both elements was required. For a survey of the cases requiring loss causation, see Kaufman, supra note 25, § 11.1.
veloped the twin requirement framework for traditional reliance based actions, they apparently felt bound to apply it to fraud-on-the-market actions as well after this new alternative theory of liability became accepted. This effort of the lower courts to cram fraud-on-the-market cases into the ill fitting transaction causation/loss causation framework has led to muddy legal reasoning and consequent arbitrary results.

1. Transaction Causation

Although the lower courts continue to reiterate the idea that transaction causation means that the defendant’s misstatement induced the plaintiff’s purchase, the success of plaintiffs in pleading and proving transaction causation never seems to be an issue in fraud-on-the-market cases. This is odd given that a substantial portion of the plaintiffs in a typical fraud-on-the-market class action almost certainly would have purchased even if the misstatement had not been made. The courts seem satisfied by the fact that the plaintiffs have shown some sort of reliance. This effort at resolution ignores the fact that although traditional reliance and transaction causation are just two names for the same “but for” concept of causation, the Basic type of reliance on the integrity of the market price that characterizes fraud-on-the-market cases is not the same as transaction causation. By glossing over this distinction, the courts make the transaction causation requirement, which logically should not be there at all, trivially easy to meet. This tactic is innocent enough by itself. After all, as we have seen, if they seriously tried to apply the requirement, they would essentially be reversing the Supreme Court’s decision in Basic, because the whole point of the fraud-on-the-market action is to allow suits to be brought by plaintiffs who cannot show that the defendant’s misstatement caused their purchases. The tactic has had an unfortunate side effect, however. By allowing courts to avoid the reality that no real transaction causation exists, it creates much confusion as to what the standard for loss causation should be.

2. Decisions Finding that Price Inflation Constitutes Loss Causation

Recall the meaning of loss causation, as it was originally developed in the case law: a showing by the plaintiff that the purchased security declined in value from


40. Some courts in fraud-on-the-market cases include as part of the required showing of loss causation a component that sounds more like transaction causation, i.e., that the plaintiff must plead and prove that if he had known the truth, he would not have purchased. See Bryant, 25 F. Supp. 2d at 1382; Valujet, Inc., 984 F Supp. at 1480. Based on pleadings to this effect, the courts in these cases denied motions to dismiss the complaints. Such a pleading really fails to address whether the plaintiff would have purchased the shares “but for” the misstatement, however. Nor is it very believable in most cases arising out of purchases in an efficient secondary market. If the plaintiffs, who were outside investors, had known the truth, so would the market. The shares might therefore have been an equally attractive purchase because the market price would have been commensurately lower, compensating for the less rosy, true situation.
what was paid or was sold at a loss and that the decline or loss is in some way reasonably related to the falsity of the statement that induced the purchase. Some courts conclude that a showing that the price at the time of purchase was inflated by the misstatement is sufficient to constitute loss causation. Typically they simply assert this to be the case and make no attempt to explain how their conclusion relates to the meaning of loss causation as it was originally developed in the case law.  

The approach of these courts that a showing of price inflation satisfies the requirement of loss causation has at least two defects in terms of legal reasoning. First, although the courts acquiesce to the idea developed in the prior case law that the plaintiff must make a certain showing, i.e., “loss causation,” they provide no reasoning as to how the new meaning that the court assigns to the term relates to the meaning developed in the prior case law that established the requirement. Nor do they try to establish how, in the different context of fraud-on-the-market suits, a showing of price inflation satisfies the purposes for which the original loss causation requirement was developed. Second, the approach redefines loss causation in such a way that the same evidence that these courts find satisfies the transaction causation requirement—that the misstatement caused an inflation in the price the plaintiff paid at the time of purchase—satisfies loss causation as well. Thus, the new definition renders loss causation, which is supposed to be an additional requirement beyond transaction causation, totally redundant.

Although these courts do not do so, one could argue that allowing a showing of price inflation to satisfy the loss causation requirement in fraud-on-the-market cases sensibly relates to the traditional loss causation formulation because, if a false statement inflated price at the time of purchase, the market, through one route or another, ultimately will reflect the true situation. After that point, the price will be lower than it would have been if the market had never realized the true situation. This argument has defects of its own, however. First, in essence, it simply redefines in ex post terms the ex ante reality that the plaintiff paid more for the security than she would have “but for” the wrongful misstatement. The ex post fact that the price is lower than it would have been if the market had never realized the true situation hardly seems like a compelling reason for compensation. The reason for compensation, if there is one, comes from the ex ante reality that the plaintiff was forced to pay too much. Second, when the market realizes the true situation, the price will not necessarily be lower than the price the plaintiff paid because, between the time of the purchase and the point of market realization, other factors may have pushed price up by more than the removal of the misstatements’ price inflation pushed it down. Therefore, even if the misstatement inflated the price paid, the plaintiff may not have suffered a loss ex post, as required by the traditional loss causation formulation. Third, if all the

41. This is the approach of the two leading appellate opinions that hold that in a fraud-on-the-market case, a showing of price inflation satisfies loss causation. See, e.g., Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824, 831 (8th Cir. 2003); Knapp v. Ernst & Whinney, 90 F.3d 1431, 1438 (9th Cir. 1996). This is also the approach used in the Ninth Circuit opinion in Broudo, now under review in the Supreme Court. Broudo v. Dura Pharms., 339 F.3d 933, 937–38 (9th Cir. 2003).
The plaintiff has to show to satisfy the loss causation requirement is that the misstatement inflated price at the time of purchase, she does not need to show, as the traditional loss causation formulation requires, that she held until the point that the market realized the true situation. If she sold earlier than that point, she may have recouped at sale the amount of overpayment at purchase.

3. Decisions Finding a Showing of Price Inflation Insufficient to Satisfy the Loss Causation Requirement

Other courts conclude that a showing that the price at the time of purchase was inflated by the misstatement is insufficient to constitute loss causation and appear to require the same showing in fraud-on-the-market cases as in traditional reliance cases. Robbins v. Koger Properties, Inc. and Semerenko v. Cendant Corp. are the two leading recent appellate court opinions taking this position. The reasoning in each also has serious problems.

In Robbins, the Eleventh Circuit rejects the price inflation theory by the following route: First, it states that transaction causation is equivalent to reliance and is “akin to actual or ‘but for’ causation.” Second, it says that the Supreme Court, in articulating the fraud-on-the-market theory in Basic, found that a showing of price inflation “supports a rebuttable presumption of reliance,” that the Robbins court says is “more closely related to the transaction causation,” and “not a presumption of causation.” Therefore, the court refuses to find that the fraud-on-the-market theory eliminates the loss causation requirement. Rather, it continues to “require proof of a causal connection between the misrepresentation and the investment’s subsequent decline in value.”

As discussed above, the reasoning in the Robbins opinion ignores the fact that the kind of reliance established by the Supreme Court in Basic is not “but for” causation and hence a showing that satisfies the fraud-on-the-market kind of reliance is not a showing of transaction causation. The reasoning ignores as well that in Basic the Supreme Court describes a showing of price inflation as providing the plaintiff an alternative way to demonstrate “the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury,” thereby suggesting that the Court did regard a showing of price inflation as creating a presumption of causation. The reasoning also ignores the fact that because the fraud-on-the-market reliance standard is not “but for” causation, there is no need for a showing of something more in the form of traditional loss causation in order to save defendants from insuring risks unrelated to the subject matter of the misrepresentation. Finally, the reasoning in Robbins ignores the special situations existing in the traditional reliance based cases, where the loss causation requirement

42. Robbins, 116 F.3d at 1448.
43. Semerenko, 223 F.3d at 185.
44. Robbins, 116 F.3d at 1447.
45. Id. at 1448.
46. Id.
47. See supra Part II B.1.
was developed, that justified the unusual focus on \textit{ex post} rather than \textit{ex ante} injury, i.e., that these cases typically arose out of face-to-face or thin or initial market situations where the purchase price paid by the plaintiff is not determined in, or guided by, a price in an established, efficient secondary trading market.

In \textit{Semerenko}, the Third Circuit also rejects the inflation theory, stating that “an investor must also establish that the alleged misrepresentations proximately caused the decline in the security’s value to satisfy the element of loss causation.”\(^49\) It does so on a more policy oriented basis, however. The \textit{Semerenko} court’s concern is that “[w]here the value of the security does not actually decline as a result of an alleged misrepresentation . . . the cost of the alleged misrepresentation is still incorporated into the value of the security and may be recovered at any time simply by reselling the security at the inflated price.”\(^50\)

The court is certainly right that a plaintiff who sells before full market realization of the truth should have his damages reduced or eliminated by the extent to which the price continues to be inflated by the misstatement. But full elimination of this price inflation, and hence of the Third Circuit’s worry, does not require that price at time of plaintiff’s sale be below the price he paid, as is required under the traditional loss causation formulation. Other factors may have increased share price by more than the full deflation reduced it. Moreover, as more fully discussed below, the problem of sales prior to full deflation is, for a number of reasons, better considered in terms of the determination of individual damages rather than causation.\(^51\)

\section*{III. The Proper Approach to Causation in Fraud-on-the-Market Cases}

\subsection*{A. The Proposal}

The Supreme Court did not develop the twin requirements of transaction causation and loss causation; indeed it has never even commented on them. The Supreme Court is therefore in a particularly free position to end the confusion caused by the lower courts’ misapplication of a framework of their own making and to throw out, for fraud-on-the-market suits, these ill fitting requirements. The Court should substitute in their place the simple requirement, consistent with its reasoning in \textit{Basic}, that the plaintiff plead and prove that the defendant’s misstatement inflated the price the plaintiff paid. This is the injury suffered by the

\(^{49}\) Semerenko v. Cendant Corp., 223 F.3d 165, 185 (3d Cir. 2000).

\(^{50}\) Id. The court made this statement to suggest that earlier Third Circuit opinions that appeared to adopt the price inflation theory of loss causation might be wrong. What the Third Circuit rule is at this point was not tested by this case, however, because the court found that the complaint alleged that the stock involved “was ‘buoyed’ by the defendants alleged misrepresentations, and that it dropped in response to disclosure of the alleged misrepresentations,” \textit{Id.} at 186, and so the appellate court would have vacated the district court’s granting of defendants’ motion to dismiss under either approach.

\(^{51}\) See infra Part III.D.
plaintiff and therefore the loss on which the causation analysis should focus.\textsuperscript{52} Her damages should be the full amount of the price inflation at the time of purchase, unless, as discussed below, the plaintiff sells prior to the market completely realizing the true situation.\textsuperscript{53}

**B. Bringing Causation Analysis into the Modern Era**

The approach advocated here would not only end confusion. It would bring the analysis of causation in fraud-on-the-market cases in line with the modern economic thinking that has been the driving force behind the evolution of securities regulation over the last two decades. This thinking has an \textit{ex ante} focus and is concerned with the law’s effects on the structure of incentives of the various actors involved at the time the plaintiff enters into the transaction. The \textit{ex ante} focus calls for use of the “out of pocket” measure of damages, i.e., the extra amount the plaintiff pays at time of purchase because of the misstatement. As we have seen, unlike actions based on traditional reliance, there are no strong reasons in the case of fraud-on-the-market actions to depart from this measure.\textsuperscript{54} The “out of pocket” measure has in fact all along been the standard measure of damages in Rule 10b-5 cases generally.\textsuperscript{55} As noted earlier, it is only logical that in an action for compensatory damages, the form of loss for which we make a causation determination should correspond to the measure of damages. Thus, in asking the question of whether the defendant’s misstatement caused the plaintiff’s loss, the loss that is the subject of inquiry should be the amount by which the misstatement inflated purchase price.

In this regard, it is worth noting that the approach to causation advocated here corresponds to the well known 1982 article in this journal by Daniel Fischel, in which he argues, using modern finance theory, that in cases involving actively traded securities, proof of materiality, causation, and measure of damages should all go to the same issue: the amount that the misstatement inflated the share price.\textsuperscript{56} Although the Supreme Court in Basic\textsuperscript{57} cited Fischel’s article, the lower courts have largely ignored its implications as they have fashioned a post-Basic...

\textsuperscript{52} Professor Coffee, in his comment on this Article, seems at points to suggest that because I advocate that plaintiffs in fraud-on-the-market cases not be required to establish traditional loss causation, i.e., that the security declined in price after it was purchased and that the decline was in some way reasonably related to the misstatement, I advocate dispensing with a causation requirement altogether. John C. Coffee, Jr., \textit{Causation by Presumption?: Why the Supreme Court Should Reject Phantom Losses and Reverse Broudo}, 60 BUS. LAW. 533, 539–40 (2005). In fact, my approach retains the causation requirement: the plaintiff must plead, and prove at trial, that the misstatement caused the price at which the plaintiff purchased to be higher. Although it is not an essential part of my approach, in my view, consistent with Basic, it would be better that where the plaintiff successfully pleads that the misstatement is material, there should be for pleading purposes a presumption that the misstatement inflated the purchase price. See infra Parts III.E & VB.

\textsuperscript{53} See infra Part III.D.

\textsuperscript{54} See supra Part II.B.

\textsuperscript{55} See supra note 31 and accompanying text.


\textsuperscript{57} Basic Inc. v. Levinson, 485 U.S. 224, 246 n.24 (1988).
theory of causation for fraud-on-the-market cases. The Court now has the opportunity to correct this neglect.

C. COMPARATIVE EXAMPLES AND THEIR POLICY IMPLICATIONS

The differences between the approach proposed here and the application of the traditional loss causation requirement to fraud-on-the-market cases are illustrated in the following examples. In the first example, XYZ corporation violates Rule 10b-5 by falsely announcing on June 1 a large increase in the sales of its food division. This inflates XYZ’s share price by $10, resulting in its shares trading at $60 instead of $50. Later the same day, A buys a share in the secondary market at the $60 price. Two things happen thereafter during the month of June: the Bolivian government confiscates XYZ’s mineral properties in Bolivia (part of a business unrelated to food) and the market realizes the truth about the food division’s sales. As a result, by July 1, the price has gone down from $60 to $30 (i.e., the confiscation subtracts $20 from the price and the realization of the truth about the food sales subtracts another $10, for a total decline of $30). On July 1, suit is brought. A has not sold. Under the approach advocated here, A’s loss due to the misstatement is $10 because the misstatement caused him to pay $10 more than he otherwise would have. He would receive no compensation for the additional $20 because what happens to the share price after the purchase is irrelevant to his injury. Application of the traditional loss causation theory would also result in the same $10 loss from the misstatement, but the reasoning would be very different: A suffers a loss because of the $30 price drop, but only $10 is considered caused by the misstatement because the other $20 in decline is not a reasonably foreseeable consequence of the misstatement.

In the second example, all the facts are the same except that in June, XYZ, instead of being a target of a Bolivian confiscation, discovers oil in Indonesia. By July 1, the price has only gone down to $55 (i.e., the oil discovery adds $5 to the price and the market realization of the truth about the food sales subtracts $10, for a net loss of $5). Under the approach recommended here, A again has incurred a $10 loss because the misstatement caused him to pay $10 more than he otherwise would have for shares. Application of the traditional loss causation requirement, in contrast, would result in the recognition of $5 in loss because that is all that the price has gone down.

These examples illustrate how the approach recommended here would make better policy. Requiring the same loss causation showing in fraud-on-the-market cases as in traditional reliance based cases results in a lack of balance in outcomes depending on whether, after the purchase, other news affecting the fortunes of the issuer is positive or negative. Investors must suffer the full downside risk associated with other news being bad. If Bolivia confiscates XYZ’s mineral properties, as in the first example above, A suffers the full $20 loss associated with the confiscation, because his right of recovery is still limited to $10, the amount by which market realization of the truth concerning the food division sales depressed the price. Under this approach, investors cannot, however, fully enjoy the upside
risks associated with other news being good, because any such gains will be eroded by market realization of the truth. If XYZ instead discovers oil in Indonesia, as in the second example above, A's damages would be $5 because that is all that the price declined. A receives none of the $5 that the good news is worth. He would be able to sell the security for $55 and receive $5 in damages for a total of $60, exactly what he paid. In contrast, under the approach recommended here, A would enjoy the full $5 value of the good news. He could sell the security for $55 and receive $10 in damages, for a total of $65, $5 more than he paid. This lack of balance in outcomes from requiring the traditional reliance based case standard of loss causation is not only unfair, it is inefficient. It distorts incentives for investors who seek to profit through hard work by anticipating, ahead of the market, news events such as confiscations and oil discoveries. Such activities are socially useful because they help improve the accuracy of share prices.

D. Sales Prior to Complete Market Realization of the True Situation

In each of these examples, under the approach recommended here, if A instead sells before the market has any realization of the truth about the food division sales, A should receive no damages. Although A was injured at the time of his purchase by the wrongful false statement, at the time of sale he receives a benefit arising from the same wrong equal in an amount to the injury he suffered earlier.58 Under the approach requiring a showing of traditional loss causation, A would also get nothing, but for different reasons. In the first example, the reasoning under the loss causation approach would be that any decline in price before A sold would not be a reasonably foreseeable consequence of the false statement because it was due to other factors. In the second example, the reasoning would be that A would receive nothing because there would not have been decline in price below what A paid.

Although the results in these simple examples are the same, the decision on whether to deal with the problem of sales prior to complete market realization of the true situation as one of determining individual damages, as I would recommend, or as one of loss causation, has important implications. Market realization of the true situation means that the price is no longer any higher than it would have been if the false statement had never been made. Market realization can occur several different ways. It can occur as a result of a single public announcement by the company to the effect that the earlier statement was incorrect or a series of smaller disclosures that gradually add up to the same conclusion. It can occur as a result of trading by insiders or others based on nonpublic information.

58. The reasoning for limiting recovery in this fashion corresponds to Judge Sneed's concurring opinion in Green v. Occidental Petroleum Corp., 541 F.2d 1335, 1341–46 (9th Cir. 1976) (Sneed, J., concurring). Professor Coffee, at certain points in his comment on this Article, seems in his examples to suggest that if the traditional loss causation requirement were eliminated, plaintiffs could collect damages based on an inflation in price which they claimed continued to exist. Coffee, supra note 52, at 538–40. Under the approach I advocate, however, such a claim would be an admission against interest and reduce the amount of damages that plaintiffs could obtain.
or rumors concerning the true state of affairs. It can also occur because the higher earnings in the future that one would have predicted based on the false statement did not materialize. It could also occur as a result of a combination of two or more of these ways. The existence of these multiple ways for market realization to occur, some of which do not operate in the open, and some of which may play out slowly over time, means that it is often not self-evident when complete (or partial) realization of the true situation has occurred.

Because it will often not be obvious as to when the market realizes the true situation, the question of who should have the burden on the matter, both at the pleading stage and at trial, is an important policy question. The matter of when the market completely realizes the truth is important, as we have seen, because it would be unfortunate if a plaintiff could recoup part or all of his injury by selling before that point in time and then collect full damages as well. If this problem of possible double recovery is dealt with by requiring the plaintiff to meet a traditional loss causation requirement, by default the burden will be on the plaintiff to establish when the market realized the true situation. At best, he is only going to be able to meet this burden if market realization occurs by a route that is public and that works quickly.

It would be much better to address head-on the policy issues involved in allocating burdens by treating the matter as one of how individual damages are determined, instead of hiding it under an otherwise ill fitting loss causation requirement that was developed to serve other purposes in a different kind of action. Treating the problem instead as one of how to determine individual damages highlights a very important fact: some members of any class bringing a fraud-on-the-market suit are likely, at the time that the issuer makes a public announcement acknowledging the true situation, still to be holding shares. This fact has two implications. First, whoever has the burden of proof at trial on the question of when the market realized the true situation, these members have unambiguously been injured by the full extent of any price inflation at time of purchase resulting from the misstatement. Thus, the causation issue for them is solely whether any price inflation occurred. In the many cases where the misstatement inflated price but traditional loss causation would be difficult or impossible to show, requiring plaintiffs to establish traditional loss causation in order to prevent double recovery would inappropriately cut out all of these members of the class. Second, the fact that some members of the class almost certainly will still be holding shares when the market completely realizes the true situation suggests that the pleading standard with respect to this issue should not be strict with regard to this issue even if the burden is put on the plaintiff.

E. APPROPRIATE EVIDENCE OF PRICE INFLATION

Consistent with the conventional out of pocket measure of damages and the general ex ante perspective that permeates modern securities law analysis, I have argued that in fraud-on-the-market cases, the appropriate loss on which to focus in the causation determination is the amount by which the defendant’s misstate-
ment inflated the plaintiff’s purchase price. Thus, the primary issue is what kinds of evidence should be admissible concerning whether the misstatement inflated the price. Requiring the plaintiff to establish traditional loss causation can be viewed as a rule that the only admissible kind of evidence concerning whether the misstatement caused an increase in the price the plaintiff paid is information showing that the share price dropped after the true situation is publicly announced. Under certain ideal circumstances, this requirement would be a reliable measure of whether the misstatement in fact increased the price paid. For these ideal circumstances to pertain, however, two conditions must be met: the market must realize the true situation all at once at the time of a public announcement, and, between the time of the misstatement and the public announcement, good news unrelated to the misstatement must not outweigh bad news. This point can be illustrated using again the example from above. Recall that the false statement about the food division’s sales on June 1 inflates XYZ’s share price from $50 to $60 on that day. For simplicity, assume that between June 1 and July 1 no other factor moves XYZ’s price. During the month of June the market has no inkling that the food division sales report is falsely positive. On July 1, XYZ makes a public announcement of the true situation and the price drops back down to $50. The loss will be $10 under either approach and the evidence put forward would be the same. Under the loss causation approach, the fact that the drop occurred immediately after the announcement of the truth would show that the misstatement was the proximate cause of the drop. Under the approach advocated here, it would reflect the fact that the misstatement did indeed increase the price paid.

As we move away from this ideal case, however, differences between the approaches appear. As discussed above, market realization of the true situation can occur several different ways, some of which are not in the open and some of which play out slowly over time. Therefore, it is very possible for a misstatement to inflate price but for the public announcement of the true situation not to be accompanied by a discrete drop in price because the market already realized, in substantial part or in whole, the true situation.

It would be difficult if not impossible for the plaintiff to establish traditional loss causation under these circumstances because it would be hard affirmatively to show that the decline in price that did occur was due to any of these slow moving or behind the scenes forces. If other kinds of evidence were also allowable, it could be considerably easier to establish price inflation. Consider what some of these types of evidence might be. To start, there might be a positive share price reaction to the initial announcement (though, probably more often, misstatements are made so as not to disappoint expectations, rather than to inflate them). The information also may be self-evidently important, as could be established, for example, by testimony of analysts or industry experts. Although plaintiffs would have to explain how such evidence could be consistent with no market reaction at the time of the public announcement of the true situation, this would be easier to establish than affirmatively proving that any price decline that did occur was due to slow acting or nonpublic mechanisms of market realization.

Behind this are some important points of policy. Where a misstatement has inflated price but, to one extent or another, the market comes to a realization of
the true situation by one, or some combination, of slow acting or nonpublic routes, the case in the abstract for awarding damages to plaintiffs is just as great as where the market becomes aware in one moment through a public announcement of the truth. But there is a tradeoff here, because often we do not know for sure whether price inflation occurred or not. When there is no reaction to a public announcement of the truth, it may be because no price inflation occurred in the first place or because market realization occurred by a different route. Other evidence of price inflation is not as definitive as a price reaction upon the public announcement of the truth. What other kinds of evidence, if any, is acceptably definitive is a policy question.

In sum, although the language of traditional loss causation is in terms of ex post loss, it is, with fraud-on-the-market actions, really looking to a specific and particularly definitive kind of evidence that the misstatement inflated price at the time of purchase. Thus, a decision to impose a traditional loss causation requirement would be a decision only to allow admission of one narrow kind of evidence of price inflation: the drop in price at the time of the public announcement of the true situation. Professor Coffee, in his comment on this Article, implicitly views the loss causation rule from this evidentiary perspective.\(^{59}\) He appears to have little trust in the ability of the judge at summary judgment and the jury at trial to deal reliably with any kind of evidence of price inflation other than a price drop after a public announcement, and so he favors the traditional loss causation requirement.\(^{60}\) It is less obvious to me that judges and juries are so incapable of dealing sensibly with anything but this one kind of evidence of price inflation at the time of purchase. Thus, I am skeptical that the traditional loss causation requirement is worth its cost in blocking suits where price inflation did in fact occur but where there was no drop in price at the time of public announcement of the true situation. The more important point, however, is to recognize that the real issue is price inflation and to self consciously address the tradeoff between admitting only the most reliable kinds of evidence that a misstatement inflated purchase price and awarding damages in a larger number of cases where price inflation in fact occurred.

The same issue arises at the pleading stage. I would advocate that the allegation of a facially material misstatement should be enough.\(^{61}\) This approach would appear to make successfully pleading a fraud-on-the-market case easier, and in my personal opinion, would be more consistent with Basic. Again, however, the more important conclusion is that price inflation is the real issue. Thus, the focus should be how specific the allegations concerning price inflation need to be for a plaintiff to be able to survive a motion to dismiss. Again there is a familiar tradeoff between strict standards that effectively block bad suits that otherwise would have settlement value, with less strict standards that would block fewer good suits.

\(^{59}\) Coffee, supra note 52, at 539.
\(^{60}\) Id. at 539–40.
\(^{61}\) See infra Part VB.
IV. ANSWERS TO COMMON ARGUMENTS FOR IMPOSING TRADITIONAL LOSS CAUSATION REQUIREMENT

Courts, commentators, and advocates in favor of requiring plaintiffs in fraud-on-the-market actions to show a causal connection between the corporate misstatement and a subsequent decline in price have offered a number of arguments in support of their position. Some of these arguments are purely the product of the confusion sown by the effort to apply the transaction causation/loss causation framework where it does not fit. These arguments disappear when this erroneous framework is abandoned. Others have real substance, but the policy issues behind them are better considered using the approach urged here, i.e., that the loss on which the causal inquiry should focus should be whether the defendant’s misstatement increased the price that the plaintiff paid.

A. ALLOWING A SHOWING OF PRICE INFLATION TO SATISFY LOSS CAUSATION MUST BE WRONG BECAUSE IT CONFLATES LOSS CAUSATION WITH TRANSACTION CAUSATION

It is frequently argued that it would be wrong to allow a showing of price inflation to satisfy the loss causation requirement because to do so would conflate the requirement with transaction causation.62 This argument, of course, assumes, contrary to the thesis of this Article, that the transaction causation/loss causation framework should be applied to fraud-on-the-market cases. The argument starts with the observation that transaction causation is equivalent to traditional reliance, which in turn is equivalent to “but for” causation. It then points to the fact that in fraud-on-the-market cases, reliance can be established by a showing of price inflation. Therefore, the argument runs, loss causation cannot also be established by a showing of price inflation because transaction causation and loss causation are separate requirements.

As discussed above, this argument ignores the fact that the presumption of reliance in fraud-on-the-market cases involves a different kind of reliance from traditional reliance and is not equivalent to “but for” causation.63 Thus, allowing a showing of price inflation to satisfy the loss causation requirement does not conflate the two requirements. The real problem is that the transaction causation/loss causation framework is incoherent in fraud-on-the-market cases and needs to be abandoned. Most fraud-on-the-market plaintiffs cannot meet the transaction causation requirement. The whole point of the fraud-on-the-market doctrine is to eliminate the need to show transaction causation.

B. ALLOWING A SHOWING OF PRICE INFLATION TO SATISFY LOSS CAUSATION WOULD ALLOW DOUBLE RECOVERIES

A plaintiff who sells before full market realization of the truth will receive a double recovery unless his damages are reduced or eliminated by the extent to

63. See supra Part II.C.3.
which the price continues to be inflated by the misstatement. It is argued that requiring the plaintiff to show traditional loss causation is necessary to prevent this kind of double recovery.64

Although requiring a showing of traditional loss causation is one way to prevent such double recoveries, it is not the only way. Moreover, as discussed above, such a requirement is not a very efficient way of dealing with the problem because it can partially or fully block recovery by many persons who were in fact injured by the misstatement by paying too much and who still own the stock when the market realizes the truth. Such persons have no potential for garnering a double recovery. They can nevertheless be blocked from suing for their full damages by a traditional loss causation requirement when there is news independent of the misstatement that has a positive effect on share price, thereby reducing or eliminating the difference between the price paid and the price at the time of suit. They can also be blocked when the market realizes the true situation in a way other than through a public announcement, because, under these circumstances, such persons may have a very difficult time establishing traditional loss causation even though the market in fact has realized the true situation.

The more efficient solution to the double recovery problem is to address the concern at the point in the proceedings where individual damages are determined. Unlike the traditional loss causation requirement solution to the double recovery problem, this solution is fully consistent with allowing a showing of price inflation to establish causation. A plaintiff who is injured by paying a price inflated by defendant’s wrongful statement should not be able to recover damages to the extent that he receives at the time of sale a benefit resulting from the same wrong. As discussed above, deciding whether the burden to establish when the market realized the true situation should be put on the plaintiff or on the defendant involves some close questions of policy.65 Even if the burden is put on the plaintiffs, those who still hold the stock at the point of the official announcement will be able to meet it automatically, whatever positive news also influenced price, and however much earlier, if at all, the market in fact realized the true situation by some other route.

C. A SHOWING OF TRADITIONAL LOSS CAUSATION IS REQUIRED BY THE PSLRA

The Private Securities Litigation Reform Act (PSLRA) added section 21D(b)(4) to the Securities Exchange Act of 1934 (the “Exchange Act”).66 This provision is entitled “Loss Causation” and provides that plaintiffs in private actions “shall have the burden of proving that the act or omission of the defendant . . . caused the loss for which the plaintiff seeks to recover damages.”67 The argument is made

65. See supra Part III.D.
67. Id.
that this provision codifies the need for plaintiffs to establish traditional loss causation.\textsuperscript{68} The weakness of this argument is that it begs the question of what is the loss with respect to which causation must be shown. The approach advocated in this Article is that for fraud-on-the-market cases, the loss with respect to which the plaintiff must show causation is the inflation in the price the plaintiff paid.

The language of section 21D(b)(4) is fully consistent with the concept that the loss that the plaintiff must show was caused by the defendant’s misstatement is that the misstatement resulted in her paying too much for the security.\textsuperscript{69} Indeed, in section 21D(b)(4), the “loss” that is referred to is “the loss for which the plaintiff seeks to recover damages”\textsuperscript{70} and, as noted earlier, the out of pocket measure of damages is the measure conventionally applied by courts in Rule 10b-5 actions.

Price inflation is the type of loss that most closely corresponds with this measure of damages. Moreover, the PSLRA’s legislative history supports the conclusion that a showing of price inflation satisfies the requirements of section 21D(b)(4). The Conference Report, in explaining that the purpose of section 21D(b)(4) is to require the plaintiff to plead and prove that the misstatement “actually caused the loss incurred by the plaintiff,” goes on to say, “[f]or example, the plaintiff would have to prove that the price at which the plaintiff bought the stock was artificially inflated as the result of the misstatement.”\textsuperscript{71} It is also significant that there existed

\textsuperscript{68} See, e.g., Cert. Pet. Amicus Brief for the United States, supra note 2, at *10–*13.

\textsuperscript{69} The government seeks to deny that this is a reasonable reading of the provision by stating “[a] loss is a decline in value, and in a fraud-on-the-market case, that necessarily occurs at a point in time after the purchase.” Brief for the United States as Amicus Curiae Supporting Petitioners at 7–8, Dura Pharm., Inc. v. Broudo, 124 S. Ct. 2904 (2004) (No. 03-932) [hereinafter Amicus Brief of the United States] (emphasis in original). This narrow interpretation of the word “loss” seems contradicted by the government elsewhere in this same brief and in its own earlier brief in support of the defendant’s certiorari petition. In these briefs, the government makes statements such as “[t]he inflation attributable to the untruth . . . could also be removed through an increase in the price that is smaller than it otherwise would have been,” id. at 7, and “[a] decline in price may not be a necessary condition for loss causation, however, because the inflation attributable to fraud could be reduced or eliminated even if there were a net increase in price.” Cert. Pet. Amicus Brief of the United States, supra note 2, at *13. An additional problem with this narrow reading of “loss” arises in the case of a fraud-on-the-market suit by a plaintiff who sold shares of an issuer for less than he otherwise would have received because of a negative misstatement on the part of the defendant and who never repurchases the shares. See supra note 2. According to the logic of the narrow definition, even though the plaintiff never repurchases, he does not suffer a “loss” until after market realization of the truth. Such a conclusion defies common sense.


\textsuperscript{71} H.R. Conf. Rep. No. 104-369, at 41 (1995). In terms of Congressional intent concerning the meaning of the word “loss” in section 21D(b)(4), the government argues that notwithstanding this example, Congress must have intended to require a showing of a loss after purchase because the PSLRA also added to section 12 of the Securities Act of 1933 (the “Securities Act”) a provision that it also referred to as relating to “loss causation.” The addition to section 12 enables a defendant to reduce liability to the extent that he can show that the amount otherwise recoverable represents “other than the depreciation in value of the . . . security” resulting from the misstatement. 15 U.S.C. § 77k(b)(4). The government states, “there is no reason to believe that Congress had two different standards of loss causation in mind when it enacted the PSLRA.” Amicus Brief of the United States, supra note 69, at 8. The problem with the government’s argument is that the prima facie measure of damages in a section 12 claim is recisionary: the difference between the price paid and the price at the time of suit. Thus, any loss causation limitation on section 12 damages would inevitably have to be phrased in terms of a reduction in damages so measured. In contrast, the ordinary measure of damages in a Rule 10b-5 action is the out of pocket measure and hence there is no need to phrase a limitation on these damages in terms of a depreciation in the value of the security.
appellate decisions prior to the passage of the PSLRA holding that a showing of price inflation is sufficient to demonstrate loss causation.\textsuperscript{72}

\textbf{D. FRAUD-ON-THE-MARKET SUITS SHOULD NOT BE ENCOURAGED BY A LIBERAL RULE OF CAUSATION}

Professor Coffee, in his comment on this Article, argues that the approach to causation advocated here would lead to a larger number of fraud-on-the-market actions than would the traditional loss causation requirement.\textsuperscript{73} He questions the desirability of this result because a larger number of actions means a larger amount of associated transaction costs.\textsuperscript{74} These costs are primarily the fees that both sides pay to the legal profession, costs that are ultimately borne largely by shareholders. Coffee points out, correctly, that in the secondary market trading cases where fraud-on-the-market causes of action arise, the losses by the plaintiff purchaser, who pays too much, are counterbalanced by the gains of the seller, who receives too much.\textsuperscript{75} The seller is usually also an outside investor, unrelated to the suit, who is equally in the dark. From a societal point of view, therefore, because issuers pay most of the damages and thus they ultimately come from the pockets of issuer shareholders, fraud-on-the-market suits primarily redistribute wealth among innocent investors. Accordingly, Professor Coffee feels that the compensatory justification for such suits is weak,\textsuperscript{76} a conclusion with which I tend to agree.

Fraud-on-the-market actions can have an efficiency justification as well, however, and this justification may be much stronger than the compensatory justification. As Professor Coffee acknowledges, such actions deter corporate misstatements.\textsuperscript{77} A lower level of corporate misstatements increases share price accuracy. Greater share price accuracy makes the economy more efficient through improvements in how new projects in the real economy are selected for implementation and, by increasing the effectiveness of a number of devices that limit the extent to which managers of public corporations place their own interests above those of their shareholders, through improvements in how existing projects are run.\textsuperscript{78} A lower level of corporate misstatements also lowers investor precaution costs and the resources secondary market traders and their advisors expend trying to detect misstatements so as to avoid losing transactions.

The question of the role of private civil litigation in deterring issuer misstatements in situations where neither the issuer nor its insiders engage in significant trading is a complicated one. It involves a variety of rules beyond causation re-

\textsuperscript{72} See, e.g., In re Control Data Corp. Sec. Litig., 993 F.2d 616, 619–20 (8th Cir. 1991) (stating “[t]o the extent that the defendant’s misrepresentations artificially altered the price of the stock and defrauded the market, causation is presumed”).

\textsuperscript{73} Coffee, supra note 52, at 537.

\textsuperscript{74} Id. at 542.

\textsuperscript{75} Id. at 534.

\textsuperscript{76} Id. at 542–43.

\textsuperscript{77} Id. at 543.

quirements, including, among others, rules determining how difficult it is to sue various potential defendants (issuers, directors and officers, control shareholders, accountants, etc.), the amounts that such defendants would be expected to pay out in damages, and the fees to plaintiffs’ class action lawyers. It is desirable to have a set of rules that, working together, encourage suits where the efficiency benefits exceed the costs and discourage suits where the opposite is the case. Personally, I believe that the prevailing set of rules is not perfect. They encourage some kinds of suits where the costs exceed the deterrence value and discourage some other kinds of suits where their deterrence value would exceed their costs. Imposition of a traditional loss causation rule in fraud-on-the-market suits does not appear to be a rational way of remediying this problem, however. It will arbitrarily cut out plaintiffs in cases where positive news unrelated to the misstatement has counterbalanced the effect on price from the market realization of the misstatement and in cases where the market realization occurs prior to the public announcement. There is no reason to think that the deterrence value of these cases is any less, or their costs any greater, than those of cases where traditional loss causation can be demonstrated.79

V. APPLICATION TO BROUDO

A. BACKGROUND

The class action plaintiffs in Broudo were open market purchasers of shares of defendant Dura Pharmaceuticals (“Dura”). They allege that they have been damaged as a result of Dura falsely claiming progress on an asthma medication delivery device that the Food and Drug Administration (FDA) ultimately found not approvable. The alleged misstatements were made in a series of press releases issued from April 1997 through January 1998. In February 1998, Dura announced that it expected lower-than-forecast earnings and its share price dropped sharply. In November 1998, Dura publicly announced the FDA finding. The plaintiffs do not allege that the November announcement was followed by a price drop.80

The district court dismissed the complaint in Broudo for failure to state a claim. It decided that, because the complaint did not allege any relationship between

79. As discussed previously in Part III E, the traditional loss causation rule, although not normally discussed in these terms, can, consistent with the approach to causation advocated here, be viewed not as a rule relating to causation, but as a rule concerning the kind of evidence that can be introduced to establish price inflation at the time the plaintiff purchased. Only one narrow kind of evidence of price inflation at the time of purchase can be admitted: the drop in price at the time of the public announcement of the true situation. Viewed as an evidentiary rule rather than a causation rule, the traditional loss causation requirement is not self-evidently irrational. Its desirability would depend on the ratio of suits it blocks where such price inflation in fact did occur compared to the number it blocks where price inflation did not occur. Professor Coffee implicitly views the loss causation rule from this evidentiary perspective. He appears to have little trust in the ability of the judge at summary judgment and the jury at trial to deal reliably with any kind of evidence beyond this one narrow kind. Coffee, supra note 52, at 538–39. Thus, he believes that the ratio is low and hence that the traditional loss causation rule is desirable. Id. It is less obvious to me that judges and juries are so incapable of dealing with any evidence outside this very narrow range that it is worth losing the deterrence value of the suits that are blocked where price inflation in fact did occur.

80. The price in fact fell twenty-one percent, from $12 3⁄8 to $9 3⁄4.
the negative FDA finding and the February price drop, the plaintiff failed to plead “loss causation.”81 The Ninth Circuit reversed, requiring only a “pleading that the price at the time of purchase was overstated and sufficient identification of the cause.”82 The Supreme Court granted certiorari on whether, contrary to the Ninth Circuit’s position, a plaintiff in a fraud-on-the-market suit such as Broudo must demonstrate loss causation by pleading and proving a causal connection between the misstatement and a subsequent decline in price.83 Defendants, in support of their position that such a demonstration is required, cite opinions, discussed in this Article, from other circuits.84 They were joined in their certiorari petition by an amicus brief from the Solicitor General and the Securities and Exchange Commission.

B. APPLICATION OF THE RECOMMENDED APPROACH

Applying the approach recommended here to Broudo, plaintiffs have alleged that the statement claiming progress on the asthma medication delivery device was materially false. The claim of materiality is facially plausible. Because Dura traded in an efficient market, such a statement can be presumed to have inflated the price paid for its shares. Thus, the pleadings are satisfactory as to causation. In a summary judgment motion, the defendants would have the opportunity to argue that there is no genuine issue of material fact as to the truth of the statement or as to the materiality of any errors contained therein in the sense that there is a substantial likelihood that a reasonable investor would consider the claimed progress on the device important in deciding whether to buy, sell, or hold their Dura shares. If plaintiffs survive any such motion, they would need to prove the material falsity of the statement at trial and, to establish the measure of damages, the amount by which the statement inflated price. The plaintiffs will have to try to prove the amount of any such inflation by using expert testimony. This testimony will presumably be based at least in part on the twenty-one percent drop in price that, though not alleged, in fact followed announcement of the FDA finding.85

82. Broudo v. Dura Pharms., Inc., 339 F.3d 933, 938 (9th Cir. 2003).
85. The share price recovered within two and a half weeks, however. Defendants will presumably argue that this recovery reflects the market’s more sober evaluation of the stock. Based on this more sober evaluation, they would say there was no price drop. Even if defendants succeed in this argument, the plaintiffs might still prevail. The absence of a price drop might indicate that the original misstatement was not materially false and did not inflate the price paid. Alternatively, however, the misstatement might have been materially false and inflated the price, but there was no post-announcement price reaction because the market had already gradually realized the truth. See supra Part III.D. To show this alternative to be the case, the plaintiffs would need to use other, more indirect indications than a post-announcement price drop that the price was inflated. The range of what other kinds of evidence the plaintiff should be allowed to present is, of course, a policy issue itself that the Court might wish to address. Again, application of the traditional loss causation requirement would make this policy decision by default because then only evidence of a discrete price drop following a public announcement of the true situation would count as evidence of a loss.
All members of the class who did not sell before the market completely realized the true situation would be entitled to damages equal to the amount of inflation so proven. The Court needs to decide, weighing the various policy considerations involved, whether the burden of proof at trial concerning when the market realized the true situation should, as a general matter, be on the plaintiff or the defendant. In any event, whichever party has the burden of proof at trial on this question, it is clear that the market completely realized the true situation after the November 1998 announcement of the FDA finding. Any members of the class who still held the shares after that date are entitled to damages equal to the full amount, if any, that the plaintiffs prove the alleged misstatements inflated the price.

VI. CONCLUSION

What a plaintiff needs to show to establish causation in a fraud-on-the-market suit has been a subject of great confusion. This confusion is the result of the lower courts feeling bound to analyze the question in terms of the twin requirements of transaction causation and loss causation. These twin concepts were developed in the context of Rule 10b-5 misstatement cases based on a showing of traditional reliance. They fit traditional reliance based cases reasonably well. Fraud-on-the-market cases, however, involve a fundamentally different causal link between the defendant’s misstatement and the plaintiff’s injury, as recognized by the Supreme Court in Basic. Because of this difference in causal link, transaction causation and loss causation are nonsensical concepts within the context of fraud-on-the-market actions. The attempt by the lower courts nevertheless to apply this framework to fraud-on-the-market actions has led to the confusion we now witness. The Supreme Court has the opportunity to end this confusion by avoiding the transaction causation/loss causation framework in its analysis of causation in fraud-on-the-market cases and instead focusing on what the plaintiff must plead and prove in order to establish that the defendant’s misstatement inflated the price paid.